United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

74-2147

IN THE

United States Court of Appeals

For the Second Circuit

Appeal No. 74-2147

HARRY ERNEST RUBENS and JEANNE RUBENS,

Plaintiff-Appellants

v.

NEW YORK STOCK EXCHANGE, INC., KIDDER, PEABODY & CO., INC., MERRILL, LYNCH, PIERCE, FENNER & SMITH, INC.,

Defendant-Appellees

On Appeal from the United States District Court for the Southern District of New York

BRIEF FOR PLAINTIFF-APPELLANTS

PETER L. BERGER
Attorney for Plaintiff-Appellants
370 Lexington Avenue
New York, New York 10017
(212) 685-5766

TABLE OF CONTENTS

PREFACE

Cases Cited

Wilko v. Swan, 346 U.S. 427 (1953)

Pearlstein v. Scudder & German 429 F. 2d 1136, (2d. Cir. 1970), cert. denied 401 U.S. 1013 (1971)

Statutes

The following were cited in Wilko v. Swan: 48 Stat. 74, 15 U.S.C. 77a et seq. 12(2), 48 Stat. 84, 15 U.S.C. 77(1) (2), provides: "Any person who...

" (2) sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section 77c), by the use of any means or instruments of transportation in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security." (Cited, page 428)

77(n) 14 provides:

"Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void." (Cited, page 430)

77v (a) 22(a) provides:

"The district courts of the United States...shall have jurisdiction... concurrent with State and Territorial Courts...of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter. (Cited, page 433)

The following sections are the so-called Anti-Fraud Section of the Securities Act:

Sec. 10 *** (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Sec. 15(c) *** (1) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for the purposes of this subsection, by rules and regulations define such devices or contrivances as are manipulative, deceptive or otherwise fraudulent.

Sec. 17(a) Every national securities exchange, every mem[illegible]hereof, every broker or dealer who transacts a business in securities through the medium of any such member, every registered securities association, and every broker or dealer registered pursuant to section 15 of this title, shall make, keep, and preserve for such periods, such accounts, correspondence, memoranda, papers, books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe, as necessary or appropriate in the public interest or for the protection of investors. Such accounts, correspondence, memoranda, papers, books, and other such records shall be subject at any time or from time to time to such reasonable periodic, special, or other examinations by examiners or other representatives of the Commission as the Commission may deem necessary or appropriate in the public interest or for the protection of investors.

Sec. 29(a) See 77(n) 14, above.

IN THE

United States Court of Appeals

For the Second Circuit

Appeal No. 74-2147

HARRY ERNEST RUBENS and JEANNE RUBENS,

Plaintiff-Appellants

v.

NEW YORK STOCK EXCHANGE, INC., KIDDER, PEABODY & CO., INC., MERRILL, LYNCH, PIERCE, FENNER & SMITH, INC.,

Defendant-Appellees

On Appeal from the United States District Court for the Southern District of New York

BRIEF FOR PLAINTIFF-APPELLANTS

ISSUES PRESENTED FOR REVIEW

(1) Is a broker who buys and sells a customer's securities entitled to receive as compensation more than the accepted buying and selling commissions.

(2) Did the District Court err in upholding the conduct of the broker in a) withholding the selling price of a customer's securities, b) using the proceeds for the broker's private gain, and c) charging interest on a fictitious loan.

(3) Did the District Court err in granting a stay of proceedings under the Federal Arbitration Act to a party charged with violation of the Securities Act.

STATEMENT OF THE CASE

1. NATURE OF THE CASE

This case is before the Court of Appeals from three orders of the District Court:

One dated October 9th, 1973 granting a stay of proceedings;

One dated March 18th, 1974 dismissing the complaint against Kidder, Peabody & Co., Inc. (KIDDER), and

One dated July 10th, 1974, dismissing the complaint against Merrill, Lynch, Pierce, Fenner, & Smith., Inc. (MERRILL LYNCH) and the New York Stock Exchange, Inc., (NYSE).

2. THE PARTIES

The plaintiffs are security holders who have brought suit against the NYSE and two of its members, KIDDER and MERRILL LYNCH, alleging violations of the fraud sections 10(b); 15(c) (1) and 17(a) of the Securities Act.

3. THE PLEADINGS

The defendants KIDDER and MERRILL LYNCH are charged with selling plaintiffs' interest in their securities, wrongfully withholding the selling price, while using the proceeds for the brokers' own gain, and charging interest (or requiring additional cash) to cover a rise in the market price of the securities thereafter.

All the defendants are charged with an agreement among themselves, to approve the wrongful conduct of the brokers, including the deceptive use of a customer agreement requiring compulsory arbitration of all future claims in violation of the Securities Act.

4. BACKGROUND:
THE COMPULSORY ARBITRATION AGREEMENT

Plaintiffs initially sued KIDDER in the New York State Court for return of the interest improperly charged. KIDDER requested a stay alleging a compulsory arbitration agreement executed by plaintiffs before the controversy arose.

The State Court upheld the agreement and issued a *subpoena duces tecum* to plaintiffs for the arbitration.

Plaintiffs thereafter demanded that the proposed panel of arbitrators, required by KIDDER to be selected by the New York Stock Exchange, be free of persons involved in the brokerage business. When two brokers on the panel refused to disqualify themselves, plaintiffs filed suit in the District Court.

5. THE COURSE OF THE PROCEEDINGS

Without joining issue with an answer, defendant KIDDER moved for a stay under Sec. 3 of the United States Arbitration Act 9 U.S.C. The District Court granted the stay (order October 9, 1973) and upon motion by defendant KIDDER dismissed the complaint as to KIDDER (order March 18, 1974).

MERRILL LYNCH answered requesting a stay, and thereafter moved to dismiss the complaint which was granted (order July 10, 1974).

The NYSE answered, and thereafter without motion, the District Court dismissed the complaint (order July 10, 1974).

STATEMENT OF FACTS

As the District Court has said, on several occasions, the facts are undisputed. They are:

(1) Plaintiffs, novices in stock exchange techniques, and desirous of protecting their security investments in an uncertain market, were advised by KIDDER, their broker, to sell their securities by means of a "box" sale.

(2) As a result, plaintiffs gave the broker KIDDER 3000 shares of Eastern Gas & Fuel Associates (EGF) and 2900 shares of Detroit Steel Corp. (DS), simultaneously giving MERRILL LYNCH 3000 shares of Great Western Financial Corp. (GWF).

(3) The brokers deposited the plaintiffs' shares in the "box" or "cashier's cage," transferring the ownership of the shares from plaintiffs to the brokers.

(4) The sales for plaintiffs were made from the "box" or "cashier's cage" of broker-held securities.

(5) The "box" sale included shares previously registered in plaintiffs' names.

(6) The brokers received about $341,000. in cash for the sale while charging plaintiffs many thousands of dollars in commissions.

(7) The brokers retained the $341,000., using plaintiffs' money for their private gain.

(8) Several thousands of dollars were charged plaintiffs as interest for a "loan" alleged to have been made to plaintiffs, without plaintiffs' knowledge or consent.

Items 1, 2, 6 and 8 are generally admitted to by defendants.

As to Items 3, 4 and 5, the plaintiffs established that shares registered as certificates Nos. 76303, 76304, 76305, 76306 and 76307, previously registered to plaintiffs, were transferred into the name of KIDDER (Appendix p. 98a). Later (Appendix p. 98b), shares Nos. 76297, 76298, 76299, 76300 and 76301, each registered in the plaintiffs' names, along with shares Nos. 8247, 8248, 8249, 8250 and 8251 previously owned by plaintiffs, were surrendered by KIDDER and reissued as certificates Nos. N6477, N6478 and N6479 to KIDDER. Appendix p. 98c, disclosed that these latter shares Nos. N6477, N6478 and N6479 were delivered by KIDDER in the "box" sale to purchasers Harris, Upham; Eastman Dillon; Oppenheimer; and Blair, the purchasers of the 3000 shares of EGF from the "box".

The "box" sale thus included plaintiffs' own shares, establishing items 3, 4 and 5.

Item 7 was a finding of the District Court in its order dated March 18, 1974:

> "As the proceeds of sale remained with Kidder, plaintiffs *lost* the use of *their* money for a period, and Kidder used the funds in its business, including the making of *interest bearing loans to other customers.*" (Emphasis added.)

Two final facts are admitted:

(9) The brokers were acting, in carrying out items 1 to 8, in accordance with the regulations of the NYSE, admittedly an organization of member brokers. Appendix page 62, establishes that plaintiffs complained to the NYSE but were advised to arbitrate the dispute, with the NYSE as arbitrators, as per the customer agreement.

(10) The brokers, the NYSE approving, employed compulsory arbitrations agreements covering future disputes with customers, to deceive the public, despite the prohibition of Sec. 29(c) of the Securities Act and the U.S. Supreme Court holding in *Wilko v. Swan* that such an agreement is a violation of the Act.

In urging the agreement before the New York State Court, the brokers were in fact again violating Sec. 29(c). In moving in the District Court under Sec. 9, U.S.C. they were violating the Securities Act a third time.

A "BOX" SALE DEFINED

A "box" sale, as plaintiffs discovered after their initiation by defendant brokers, is a double entry bookkeeping system operated by brokers in which one side of the ledger represents all securities purchased by defendants for plaintiffs' account or held for plaintiff by the broker

> "in its cashier's cage in street name. As to all such shares of customers held in margin accounts, Merrill Lynch could, and doubtless did hypothecate them with banks, *lend them to other customers,* or otherwise deal with the shares to its own advantage." (District Court Order July 16, 1974, Appendix p. 225, emphasis added.)

The other side of the ledger is a different set of entries listing the sales of the customers.

The Internal Revenue Service accepts this double entry as two sets of separate, unconnected and unrelated transactions. Thus, if the customer repurchases the identical shares sold from the "box", the customer may treat the repurchase and "box" sale as a different transaction from the original ownership. While it subjects the customer to a

double tax rate (short term investment), the "box" sale has its advantages in a market with a relatively small change in security values.

The brokers have advantageously conceived this "box" sale for it gives the broker a double commission, one for selling and the other for repurchase. A simple sale would give the broker only a single commission, just for selling the plaintiffs' shares.

In the EGF sale, for example, the broker KIDDER obtained two commissions totalling in excess of $3000 for sale and repurchase of a single stock.

The brokers however, unhappy with just commissions on buying and selling, have attempted to cloud the simple "box" sale with mystic terminology.

The sale of plaintiffs' shares from the "box" is designated as a "short" sale, a highly speculative and usually ruinous adventure by a gambler who sells something he does not own with the hope that he can buy it back at a saving. However, if the market is "cornered" by someone who refuses to sell, the "short" seller may have to pay fantastic and unrealistic sums to persuade someone to sell him back his shares. A "short" sale requires a deposit of cash with the broker who assumes the responsibility of watching the market to see that the cash advanced will protect the broker against loss, should the market price rise. This watchful assessment he calls a "mark to the market" and it is like a call for more margin in a market recession.

The broker also retains the selling price of the "short" shares as security for repurchase responsibility.

The "box" sale however is without any broker responsibility. The broker has commingled the sellers shares in the "box" from which he randomly selects the shares for the "box" sale.

What the "box" sale transaction does is what the seller intends: it liquidates his equitable interest in the shares at the selling price. Whether the market goes up or down, the seller has his selling price intact and the market no longer has any bearing on the sale, or the brokers responsibility for the sale.

To therefore withhold the selling price of the plaintiffs' shares is without basis in a "box" sale for there is no need to secure a speculative obligation incurred in a "short" sale.

To "mark to the market" to protect the broker from a rising market obligation to insure the margin requirement is a pure deception on the seller.

The broker has by using terms like "short" sale and "mark to the market" employed terminology that should properly be used for a speculative sale by a gambler, selling something he does not own.

Plaintiffs do not fall into this category nor do plaintiffs desire to have this label pinned on them.

ARGUMENT

I

A BROKER, BUYING AND SELLING CUSTOMER'S SECURITIES, IS ONLY ENTITLED TO RECEIVE THE BUYING AND SELLING COMMISSION.

The brokers have obviously imposed a technique upon the plaintiffs which subjects the plaintiffs to added costs in buying and selling plaintiffs' securities.

The attempt by the brokers to cast plaintiffs into the role of speculative adventurers, with great financial risk, all without plaintiffs' knowledge, is unparalleled in stock exchange controlled activities.

Nothing was said to plaintiffs that indicated that the "box" transaction could subject plaintiffs to unlimited financial responsibility. Nothing was said to plaintiffs that would indicate that the brokers had the right to withhold $341,000. from plaintiffs and to loan this sum to margin account purchasers at high interest rates for the brokers' private gain, as the District Court found. (Appendix page 146.)

Nothing was said to plaintiffs that indicated that plaintiffs would be assessed interest rates based upon fictitious loans, or be required to advance the broker $6000. for selling plaintiffs' securities to reduce the interest rates, then running at above $400. per month. (Appendix page 189-190.)

The brokers apparently believe that the "box" sale is a method employed to escape the payment of income taxes. As a matter of fact, a repurchase of the "box" shares subjects the seller to twice the normal tax rate.

When plaintiffs sought the return of the interest from MERRILL LYNCH, the broker wrote (Appendix page 167):

> "...we will, if asked disclose the full history of this corrected transaction to the Internal Revenue Service. Please let us have your instructions on this matter."

This was answered by plaintiffs (Appendix page 169):

> "As for informing the Internal Revenue Service of the history of this transaction, I am surprised that you should have to ask me about it. Why would I want you to suppress any financial transaction I have had with your firm? (or any other)"

It is apparent that the brokers are determined to apply pressure upon a customer to obtain an unfair advantage. Plaintiffs here seek to bar these practices in the future.

II

THE DISTRICT COURT ERRED IN UPHOLDING THE RIGHT OF THE BROKER TO A) WITHHOLD THE SELLING PRICE OF CUSTOMERS' SECURITIES, B) USE THE PROCEEDS FOR THE BROKER'S PRIVATE GAIN, AND C) CHARGE INTEREST ON A FICTITIOUS LOAN.

The District Court found that plaintiff money was being used for the brokers' private gain. The specific words used were "...plaintiffs lost the use of their money ...". (Order dated March 18, 1974.)

The District Court thus confirmed the plaintiffs' assertion that defendant brokers were using "plaintiffs' money" for their own private gain.

Inferentially this is a finding that it was plaintiffs' shares that were sold, otherwise it would not have been plaintiff money that the brokers were using.

Thus the District Court finding that the plaintiffs actually engaged in a "short" sale, i.e. with securities borrowed by the broker for which the broker was required

to advance the current market price, i.e. "the mark to the market" is inconsistent with the holding that it was the plaintiffs' own money that the brokers were using.

The District Court erred in holding that such "conduct is in accordance with normal practice in the stock brokerage industry and is sanctioned by customs and usage of long standing." (Order dated July 16, 1974, Appendix page 225-226.)

It is unclear whether this finding refers to the defendant's entire conduct or just to the "box" sale of plaintiffs' shares.

If the plaintiffs were improperly charged with a fictitious loan for which interest was payable, and, the defendants used "plaintiffs' money" for their own private gain, as the District Court found, how can this be condoned as "normal practice," or be "sanctioned by custom and usage"? Moreover, there is nothing in the record to support the belief that the use of a "mark to the market" was ever employed before in a "box" sale. In fact, the plaintiffs believe it was hitherto used only in actual "short" sales, and not in "box" sales.

III

THE DISTRICT COURT ERRED IN GRANTING A STAY OF PROCEEDINGS UNDER THE FEDERAL ARBITRATION ACT TO A PARTY CHARGED WITH CONTINUING VIOLATIONS OF THE ACT.

The motion by the defendant KIDDER for a stay invoking *Sect. 3 of the Federal Arbitration Act 9 U.S.C.* (Appendix page 11) is exactly the motion made by the defendant Swan in *Wilko v. Swan* 346 U.S. 427 (1953) from which we quote:

> "Without answering the complaint, the respondent moved to stay the trial of the Action pursuant to Sec. 3 of the United States Arbitration Act... An affidavit accompanied the motion stating that the parties' relationship was controlled by terms of the agreements, and that while the firm was willing to arbitrate, petitioner had failed to seek *or proceed* with any arbitration of the proceeding." (id at page 429, emphasis added.)

Thus, defendants moved exactly as in *Wilko v. Swan,* using *Section 3 of 9 U.S.C.* and asserting in affidavits, exactly as here, that plaintiffs had failed "to proceed" with the arbitration.

The Supreme Court then held:

"The United States Arbitration Act contains no provision for judicial determination of legal issue.

"As the protective provisions of the Securities Act require the exercise of judicial direction to fairly assure their effectiveness, it seems to us that Congress must have intended Sec. 14 note 6, *supra,* to apply to waiver of judicial trial and review." (id at page 437.)

In support of its statement, the Supreme Court cited 66 Harv. L. Rev 1326; 53 Col. L. Rev. 735; 41 Georgetown L.J. 565; 62 Yale L.J. 985.

The Securities Act violation accordingly *cannot be supported* by a stay under the U.S. Arbitration Act, Sec. 3, 9 U.S.C.

The District Court erred in supporting such a stay under *Pearlstein v. Scudder & German,* 429 F. 2d, 1136 (2d Cir. 1970), cert. denied 401 U.S. 1013 (1971). That decision held in fact that a waiver by plaintiffs would only legalize the violations of the Securities Act, which the "requirements seek to prevent and which suits such as this one serve to discipline." (id at page 1143.)

This is precisely the issue: the defendant seeks by arbitration before a defendant, NYSE, as arbitrator, to prevent judicial determination of acts which the NYSE promulgated, authorized, and encouraged for the defendants' private gain. When brought to trial in the State Court, the defendant KIDDER and its knowledgeable and sophisticated attorneys in Securities violations, withheld from the plaintiffs, to whom the defendant owed a duty as an investor under the Securities Act, to disclose all facts relating to the contractual relationship between the parties, including the obligation to disclose that the customers were unknowingly accepting a waiver of their rights to a judicial trial.

The defendant KIDDER withheld these facts from the State Court, as well as from plaintiffs. As a result, the State Court upheld the validity of the compulsory agreement which constituted a waiver of plaintiffs rights. All this despite the concurrent jurisdiction with the State Court of all violations under the 1933 Act.

Thereafter, the plaintiffs objected to a panel set up by the NYSE and containing two of its members, thus acting as a kangaroo court. Instead of allowing this type of panel to arbitrate security act violations, plaintiffs sought refuge in the District Court.

To be effective against plaintiffs, the parties must enter into the arbitration freely, willingly and without reservation. Plaintiffs were directed to arbitrate by the State Court and deliberately entered reservation about the arbitration. (Appendix pp. 73-74, items 3,6.)

The District Court held in its order dated March 18, 1974, its right to jurisdiction of the proceeding.

> "It would seem clear that plaintiffs could have dropped their efforts to obtain redress on their state claim and begun an action in this Court... Had they done so, we would have considered the state proceedings no bar."

That is exactly what plaintiffs did. The arbitration proceeding was actually part of the State Court action when the State Court proceeding was stayed. When plaintiffs dropped the arbitration as a viable procedure, they dropped the State Court proceeding and brought suit here.

The District Court erred in staying the plaintiffs action against KIDDER and in not granting plaintiffs' motion for summary judgment on the admitted facts.

CONCLUSION

I. The District Court erroneously accepted the unsupported and contradicted allegations that defendant brokers had engaged in the sale of securities which they borrowed for plaintiffs, in the face of documentary evidence that the brokers sold the identical registered shares of plaintiffs.

Dismissal of the plaintiffs' cause of action should be reversed, and judgment given to plaintiffs, based on the facts admitted in the proceedings.

II. The NYSE, comprising member brokers, including the two broker defendants, must be held to account for allowing its members to violate the Securities Act by designating a "box" sale as a "short" sale, and by allowing the broker defendants to require compulsory arbitration agreements which are in violation of the Securities Act.

The Court erred in dismissing the cause of action against the New York Stock Exchange without motion, on the ground that the liability asserted against it by plaintiffs was "vicarious."

Dismissal of the plaintiffs' cause of action should be reversed, and judgment given to plaintiffs, based on the facts admitted in the proceedings.

III. The continuous use of compulsory arbitration agreements covering future claims against the broker is proscribed by the Securities Act and should be enjoined.

IV. The stay obtained by the defendant KIDDER under the U.S. Arbitration Act Sec. 3, 9 U.S.C. was specifically covered by Wilko v. Swan and thus improvidently granted. To assert such a defense is additionally a violation of the Securities Act. Since the facts of the conduct set forth in the cause of action against KIDDER are substantially identical with the MERRILL LYNCH allegations, summary judgment should be granted to the plaintiffs against KIDDER.

Respectfully submitted,

PETER L. BERGER
Attorney for Plaintiff-Appellants
370 Lexington Avenue
New York, New York 10017
(212) 685-5766

RECEIVED

26 1974

BROWN, WOOD, FULLER, CALDWELL & IVEY

By Gary L. Greenblatt